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IMPLEMENTATION COMPLETION REPORT

THE REPUBLIC OF KOREA

ECONOMIC RECONSTRUCTION LOAN
Loan No. 42670-KO

May 14, 1999

CURRENCY EQUIVALENTS
(as of May 13, 1999)
Currency Unit = Won (W)
US$1.00 = W1,207

ACRONYMS AND ABBREVIATIONS

ADB	-	Asian Development Bank
BOK	-	Bank of Korea
CAS	-	Country Assistance Strategy
Chaebol	-	Conglomerate
ERL	-	Economic Reconstruction Loan
FSC	-	Financial Supervisory Commission
FSS	-	Financial Supervisory Service
FTA	-	Fair Trade Act
G-7	-	Group of seven industrial countries including: the U.S., U.K., Canada, Germany, France, Italy and Japan
GOK	-	Government of Korea
ICR	-	Implementation Completion Report
IMF	-	International Monetary Fund
KAMCO	-	Korean Asset Management Corporation
KDIC	-	Korean Deposit Insurance Corporation
KFTC	-	Korean Fair Trade Commission
LIBOR	-	London Inter-Bank Offer Rate
MOFE	-	Ministry of Finance and Economy
NGO	-	Non-Governmental Organization
NPL	-	Non-Performing Loan
SAL	-	Structural Adjustment Loan
SBA	-	Stand-By Arrangement
SFO	-	Special Financial Operations

FISCAL YEAR

January 1 – December 31

Vice President	Jean-Michel Severino, EAP
Country Director	Sri-Ram Aiyer, EACKF
Sector Manager	Masahiro Kawai, EASPR
Task Manager	Danny Leipziger, LCSFP

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Preface

The Economic Reconstruction Loan to the Republic of Korea in the amount of US$3 billion was approved and made effective on December 23, 1997. The loan was fully disbursed the day of effectiveness. The loan closed on February 28, 1998.

This Implementation Completion Report (ICR) was prepared by Richard Carroll, based on interviews with staff and materials from the project file. Mr. Pieter Bottelier was the acting Sector Manager and had overall responsibility for monitoring the policy matrix for the Economic Reconstruction Loan. Messrs. Gary Perlin (Sr. VP and CFO), Sri-Ram Ayer (Country Director), Danny Leipziger (Task Manager for the loan), Nicholas Prescott (EASHN), Douglas Webb (LEGPS), David Scott (SFO), Hoon Mok Chung (EASPS), Hemant Shah (FPS), Wei Ding (PREM), Shyam Khemani (PSDBE), Clifford Garstang (LEGEA), and Ms. Laura Ard (SFO) provided comments for the ICR. Mr. Zia Qureshi oversaw production of the report.

IMPLEMENTATION COMPLETION REPORT

THE REPUBLIC OF KOREA

ECONOMIC RECONSTRUCTION LOAN

Loan No. 42670-KO

Evaluation Summary[1]

Project Origin, Objectives and Description

1. The $3 billion Economic Reconstruction Loan (ERL - Loan No. 42670-KO) was the first phase of the Bank's new ($10 billion) lending program in Korea to respond to the deepening economic crisis and emergency liquidity needs. The ERL was approved by the Board, became effective, and was fully disbursed on December 23, 1997. The objectives of the ERL were to: (1) provide emergency liquidity to restore confidence in the Korean economy; and (2) develop a framework for medium term structural reform that would serve as a basis for a program of structural adjustment lending.

2. The ERL was both the largest and fastest made loan in the history of the Bank. It disbursed the $3 billion principal in a single tranche and took less than three-weeks to process from identification to effectiveness. The decision to pursue the ERL engaged the highest level of Bank management. The ERL was also unusual because the loan was made to Korea, which had already graduated from Bank borrowing three years earlier.

3. **Policy areas under ERL.** The Government's framework for structural reforms was specified in the Government's Letter of Development Policy in December 1997 which was signed by the Minister of Finance and Economy (see President's report P-7214-KO December 19, 1997; Appendix 2). The framework consisted of five elements: (1) macroeconomic management; (2) financial sector restructuring; (3) corporate governance; (4) competition policy; and (5) labor markets and social safety nets.

[1] The Implementation Completion Report (ICR) for the Economic Reconstruction Loan (ERL) describes policies and events in Korea relating to the loan up to the implementation of the follow-up loan, the first Structural Adjustment Loan (SAL I), which was approved by the Board on March 26, 1998.

Implementation Experience and Results

Overview

4. Korea was on the verge of default by the time it contacted the IMF and the Bank. Korea could not meet its short-term liabilities, specifically, $20 billion coming due in December 1997. Another $25 billion would be due in the first quarter of 1998. Korea's foreign exchange reserves had declined to less than $5 billion in December 1997. Korea's most pressing need was an infusion of capital to stave off foreign bankers who were reluctant to roll over Korea's rising short-term debt.

5. In December 1997, the Bank, along with the IMF and the ADB and bi-lateral donors, agreed with the Government to support a program of financial and economic stabilization and structural reforms. Lending was prepared and negotiated by the Bank on a highly accelerated basis in mid-December 1997.

6. Leading up to the crisis, the Bank was not conducting economic and sector work on Korea as it would in the case of an active borrower. Because the crisis also developed suddenly, there was not time to design the ERL based on a comprehensive data analysis, nor develop detailed conditionality. Rather, it was derived mainly from still intact staff expertise on Korea and their priors about the Korean economy, as well as sector and financial distress expertise gained from countries which had earlier succumbed to the Asian Crisis.

Results

7. The most significant achievement in the immediate term was avoiding default. In addition, the rollover ratio increased, signaling that interventions had begun to restore confidence and that the probability of future default had declined. The short-term debt restructuring of $24 billion with creditor banks in New York, initiated in January 1998, lengthened maturities to 1 to 3 years, buying additional time for structural reform measures to be implemented.

Structural Reforms

8. The Government made significant progress on all major fronts associated with the ERL as the summary of actions (see Section B.) shows. Actions prior to ERL effectiveness were limited because of the urgency of the financial crisis. The vast majority of reform actions was passed in a special session of the National Assembly on February 14, 1998, which constituted many of the prior actions for the first Structural Adjustment Loan (SAL I).

9. **Financial sector reforms**. The centerpiece of the ERL policy program was restructuring and reform in the financial sector. The government committed to resolving financial institutions that were experiencing distress, including two of the country's largest commercial banks and 14 smaller merchant banks. Other financial institutions were to be subjected to strengthened oversight. Key reforms geared toward strengthening the financial system in the medium term included upgrading regulation and supervision, opening the sector to foreign investment, and

reducing government intervention in banks' business decisions. An important foundation for improving regulation and supervision was to be the merger of the four existing supervisory entities into a single agency, the Financial Supervisory Service (FSS) independent of both BOK and MOFE.

10. The performance of the ERL should be viewed as part of a broader longer-term series of efforts to stabilize the Korean economy and return it to a path of sustainable growth (see Future Operations). The overall performance and outcome of the ERL was satisfactory, as the general framework for medium term policy measures was achieved and proven to be relevant as evidenced by subsequent SAL conditions. The ERL was also successful as part of the total rescue package, because Korea averted default. This rating is consistent with the rating by EASPR of meeting development objectives (Form 590) at project close (also Satisfactory).

Bank Performance

11. Generally speaking, the Bank did respond quickly and substantially once massive default appeared inevitable. With the GOK and IMF, it engineered a credible reform framework for subsequent lending. The Bank also navigated through an extremely difficult situation in which a top performing economy with internationally recognized companies found itself, in a short time span, near collapse. Designing a program of deep and far reaching reforms and applying them to what was one of the Bank's greatest success stories was a difficult challenge for Bank staff and management.

Future Operations

12. SAL I was the immediate follow-up operation, effective March 27, 1998. SAL I ($2 billion) supported Government efforts to deepen structural reform in the financial, corporate and social (including labor markets) sectors. The next loan (SAL II) was a two tranche, $2 billion operation building on SAL I. SAL III is planned for FY2000.

Lessons Learned

13. The major lessons learned from the ERL are:

- **Maintaining a knowledge base**. The Bank should maintain access to a cadre of high level expertise that has dealt with occurences of systemic financial corporate distress, whether accessed externally or maintained in-house. The Bank's stock of experience on Korea and on emergencies in the corporate sector had dwindled to a very low level by the time of the Korean crisis. Assembling a capable team was a very ad hoc exercise. Establishing the SFO, mostly from existing staff, did establish a capacity to assist a small number of countries already in financial distress, but not to anticipate financial crises.

- **Use of non-government resources**. In-country expertise outside of government can be very useful in diagnosing economic problems, especially where there are large gaps in the Bank's knowledge or that knowledge is out of date. The Bank team made good use of Korean think tanks, universities and NGOs to supplement its knowledge base in drafting the ERL.

- **Maximize negotiation results during crises.** Care should be taken to achieve maximum negotiation results when a country faces an emergency. It is much easier to obtain agreement on reforms at that time. Because the economic crisis was so severe, the Bank and IMF were negotiating at the highest levels of the GOK where it is also easier to reach agreement quickly. Once stabilization measures begin to work, pressure is eased and motivation for reform lessens. In this crisis, the Bank did use Korea's urgent liquidity needs to secure commitment to an indicative outline of reforms. Achievement of additional conditionality and benchmarks should be guided by the trade-off between negotiating results and possible delays that could jeopardize the effectiveness of the program (in this case, the timely delivery of liquidity).

- **Consultative approach to reforms.** Creating a forum of Government, labor and business leaders for the purpose of achieving consensus on reforms affecting these three major groups is an effective vehicle to gain support for economic reforms.

- **Disclosure/transparency.** An essential initial step in resolving problems in the corporate sector is disclosure. It is the sine qua non of subsequent reforms, as well as making accurate credit assessments and regaining the confidence of foreign lenders.

- **Need for explicit competition reforms.** The ERL contained an explicitly stated, discrete set of competition reforms as a basis for sustaining the reform program. A clear set of competition policies was important to Korea because of the rent-seeking, over-investing behavior of the chaebols that had led to the crisis. The Bank could make greater use of this practice of incorporating competition measures as part of its program of lending prescriptions. Reform packages are enhanced when they include competition policies in areas such as foreign ownership, supervision of banks, and corruption.

- **Crisis management tool.** The use of parallel teams, one in Korea and one in headquarters (the latter shepherding papers through by day), was an effective way to accelerate processing of the Korea ERL.

- **Accelerated processing for emergencies.** In emergency circumstances such as the Korean crisis, the Bank demonstrated the necessity of relaxing reporting requirements in order to respond quickly and so that expertise may be freed for more substantive analysis and creative solutions.

- **Management of portfolio risk.** The Bank has to have the capacity to systematically manage a shift in the risk of its portfolio. To assess risk adjustment for capital allocation in the ERL case, Bank staff had to improvise to find pricing that would appropriately account for the sudden change in the Bank's risk profile. At the time the Korean crisis hit, the Bank's financial policy department had begun to study ways to analyze and estimate risk-adjusted return on capital in the context of the Bank's capital adequacy requirement.

- **Inseparability of program design and loan terms.** Lending terms and substantive reform program design must be negotiated together. This was not the case for ERL. In fairness, the borrower should know early on the cost of capital attached to the reform program to which it is agreeing.

- **Single tranche approach.** A single tranche policy-based operation (such as ERL), with an indicative outline of policy actions clearly laid out prior to Board approval, was an effective vehicle for rapid liquidity transfer. Although the urgency of liquidity needs limited upfront actions for ERL, follow-up SALs restored leverage to the Bank in reform negotiations after the ERL disbursed.

- **Need for stronger commitment with regionalized crises.** When a crisis is regionalized, positive results from reforms may be slower to be realized. Investor confidence is more difficult to restore as well as growth in aggregate demand. The Government and the Bank had to demonstrate greater resolve in adhering to the reform program.

- **Consistency with the Bank's business.** The Bank should adhere to a clear concept of what business it is in and be careful not to redefine its business according to the market opportunity. That the ERL provided emergency liquidity raised concern that the Bank was straying from its role as a development institution. This concern contributed to subsequent Bank policy in the form of special SALs.

IMPLEMENTATION COMPLETION REPORT

THE REPUBLIC OF KOREA

ECONOMIC RECONSTRUCTION LOAN

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PROGRAM IMPLEMENTATION ASSESSMENT

A. Objectives, Background and Description

Objectives

1. The $3 billion Economic Reconstruction Loan (ERL - Loan No. 42670-KO) was the first phase of the Bank's new ($10 billion) lending program in Korea to respond to the deepening economic crisis and emergency liquidity needs. The ERL was approved by the Board, became effective, and was fully disbursed on December 23, 1997. The objectives of the ERL were to: (1) provide emergency liquidity to restore confidence in the Korean economy; and (2) develop a framework for medium term structural reform that would serve as a basis for a program of structural adjustment lending.

Background

2. The ERL was both the largest and fastest made loan in the history of the Bank. It disbursed the $3 billion principal in a single tranche and took less than three-weeks to process from identification to effectiveness. The decision to pursue the ERL engaged the highest level of Bank management. The ERL was also unusual because the loan was made to Korea, which had already graduated from Bank borrowing (FY95). Because it was a reconstruction loan, it was designed mainly to provide an indicative framework for reform and its conditions were not as comprehensive as those of a typical structural adjustment loan (SAL). To add to its uniqueness, loan pricing was substantially higher than standard for a SAL, and the pricing and amount of the loan were not determined until Board presentation.

3. The Asian Crisis hit Korea in October/November 1997, four months after it began in Thailand. The adverse economic events leading up to the crisis set the stage for this extraordinary loan:

- A decline in the terms of trade which began in 1995, a cyclical downturn in the electronics sector in which Korea invested heavily, and an increase in the current account deficit to $23 billion by 1996
- An external debt increase to $120 billion by September 1997, over half of which was short-term
- The failure of a large chaebol, Hanbo, followed by other large failures due mainly to the financial drain caused by over-leveraging to pay for diversification

- Loss of investor confidence in the region with the geographical spread of the crisis
- The weakened ability of the government to deal with the developing crisis because of (a) election setbacks of the ruling party; (b) corruption scandals; and (c) less than full agreement on policy between the Ministry of Finance and Economy (MOFE) and the Central Bank.

4. The Government attempted to defuse the crisis on November 19 with policy measures: to deal with distressed assets, including increased funding for the Korea Asset Management Corporation (KAMCO), to bolster deposit insurance, to improve transparency of financial operations and to liberalize the capital account by increasing the scope of foreign ownership of Korean financial assets. However, when the exchange rate band for the Won was widened to +/- 10 percent, the Won plummeted, losing 50 percent of its value by December 11. Korea requested assistance from the IMF and the Bank in late November.

5. By the time Korea contacted the IMF and the Bank, it was on the verge of default. Korea was not going to be able to meet its short-term liabilities, specifically, $20 billion coming due in December 1997. Another $25 billion would be due in the first quarter of 1998. Korea's foreign exchange reserves had declined to less than $5 billion in December 1997. Korea's most pressing need was an infusion of capital to stave off foreign bankers who were reluctant to roll over Korea's rising short-term debt.

6. The ERL was prepared in close cooperation with the International Monetary Fund (IMF). The IMF Board approved a three year $21 billion Stand-by Arrangement (SBA) on December 4, 1997. The total IMF-coordinated support package, including other multi- and bilateral sources, was about $57 billion, of which the Bank pledged up to $10 billion. The package included "a second line of defense" by G-7 countries in the event of a second wave of the crisis.

Description

7. **Program elements**. The Government's framework for structural reforms was specified in the Government's Letter of Development Policy in December 1997 which was signed by the Minister of Finance and Economy (see President's report P-7214-KO December 19, 1997, Appendix 2). The framework consisted of five elements: (1) macroeconomic management; (2) financial sector restructuring; (3) corporate governance; (4) competition policy; and (5) labor markets and social safety nets. The IMF took the lead on macroeconomic stabilization measures, along with trade policy and capital account liberalization. In the financial sector, the IMF and the Bank worked together in overall financial restructuring. Specific areas of cooperation included restructuring of merchant banks and commercial banks, legal reforms, supervision and regulation, development of primary and secondary markets for securities, etc. The Bank led in the other structural reform areas in the corporate sector, labor markets and social protection.

8. The general framework for the future reform program (to be supported by SALs) was agreed prior to Board presentation. There were no issues of consistency of ERL with the Country Assistance Strategy (CAS) because Korea had graduated and there was no current CAS during ERL implementation. (A new CAS is expected to be presented to the Board in 1999.) However, at graduation, Korean authorities asked for permission to seek further Bank assistance under three contingencies: (1) political developments with North Korea; (2) a severe natural disaster; or (3) a sudden economic shock. Recent economic developments supported a case for

resumption of borrowing under the third contingency. With the establishment of the policy framework supported by ERL, the Government met the broad conditions to justify emergency Bank support of $3 billion with an overall program that envisaged lending up to US$10 billion for a two to three-year period. Annex B summarizes the policy actions outlined under ERL and developed and supported under SAL I and their status as of March 1998. Because of the urgency of the financial crisis, upfront actions under ERL were limited.

9. The ERL reform framework emphasizes a shift in incentives in financial policies and corporate governance away from those that precipitated the crisis. For years leading up to the crisis, the chaebols followed a practice of increasing leverage to diversify their holdings, which was encouraged by growing demand and a regime of subsidized interest rates. Increasing leverage also meant higher returns on equity. Financial strains associated with high leverage were viewed by the chaebols as a cashflow problem that could be remedied by a captive financial sector. But the historical pattern broke when Korea's terms of trade declined, export growth slowed, and confidence in Korea's creditworthiness among foreign creditors deteriorated, especially as the Asian Crisis spread. Concern over a healthy balance sheet did not arise until the first large chaebol went bankrupt in January, 1997.

10. **Financial sector reforms**. The centerpiece of the ERL policy program was restructuring and reform in the financial sector. The government committed to resolving financial institutions that were experiencing distress, including two of the country's largest commercial banks and 14 smaller merchant banks. Other financial institutions were to be subjected to strengthened oversight. One important mechanism for resolving distressed institutions was the purchase of non-performing loans (NPLs) by the KAMCO, which was to be strengthened financially and operationally.

11. Key reforms geared toward strengthening the financial system in the medium term included upgrading regulation and supervision, opening the sector to foreign investment, and reducing government intervention in banks' business decisions. An important foundation for improving regulation and supervision was to be the merger of the four existing supervisory entities into a single agency, the Financial Supervisory Service (FSS) independent of both Bank of Korea (BOK) and MOFE.

12. **Non-standard loan pricing**. The pricing of the ERL was another non-standard feature and was driven more by the Bank's supply of funds than Korea's credit situation. The Korean ERL was a large increase in overall Bank lending at a time when lending had not grown in net terms for several years. The Bank's capital was strained and had to be built up to maintain the 13 percent reserves to loan ratio. It was decided that the ERL be priced such that other countries would not incur higher borrowing costs as a result of this loan to Korea. Therefore, the Korea ERL could not be priced as a standard product. The features of the ERL pricing were:

- LIBOR based--6-month LIBOR plus 1 percent
- Upfront fee--2 percent of principal at effectiveness plus 1 percent of the principal one year after effectiveness and 0.5 percent two years after effectiveness
- Term--10 years
- Grace period--5 years

13. At the time of ERL approval, standard SAL pricing was 50 basis points above the Bank's cost of borrowing, with no upfront service charge. (At the time of this ICR, the SAL price is 75 basis points above the Bank's borrowing cost, and a 1.0 percent service charge-effective July 31, 1998). The Bank assessed higher upfront fees to cover the costs in making the loan. The higher fees provided additional insurance to the Bank should Korea exercise its prepayment option and protected other Bank borrowers from increased costs. A commitment fee was also part of the pricing, but was not material because the entire loan was disbursed upon effectiveness.

B. Achievement of Objectives

Recent Macroeconomic Performance and Stabilization Results

14. Macroeconomic indicators were mixed after loan effectiveness. Developments between ERL and SAL I effectiveness (March 27, 1998) include progress on stabilization of the exchange rate from a high of W1,960/$ to around W1,600/$, a stock market recovery of 45 percent from its crisis low, and an increase in reserves to $18.5 billion from $4 billion. Still, short term debt amounted to $43 billion, which was very high compared to reserves. Interest rates, which had peaked at 30-33 percent in December 1997, subsided to 20-24 percent by the time of SAL I effectiveness. Domestic corporate debt stood at about W400 trillion (roughly 100 percent of GDP), and the GDP was estimated to decline by 7 percent in 1998. The estimated budget deficit is 5 percent of GDP for 1998, along with a current account surplus of $39.5 billion owing to a large compression of imports. Exports rose in volume terms, but not in value terms due to a continuing decline in Korea's export prices. The target for usable reserves of $40 billion or 2.9 months of imports by the end of the year is expected to be exceeded by over $5 billion. This target is surpassed due to the current account surplus and strengthening of the capital account and foreign direct investment, funds from the international support package, $11 billion of which will be provided by the IMF, Bank and ADB. By February 1998, Korea had received already 72 percent of its allocation under the $21 billion (SDR15.5 billion) IMF SBA.

Table 1 Selected Economic Indicators

Real GDP % change	8.9	7.1	5.5	-7.0	-1.0
Gross domestic inv.-% of GDP	37.0	38.4	35.0	22.1	29.5
Gross national saving	35.2	33.7	33.1	35.4	36.2
CPI-end period	4.7	4.9	6.6	5.5	3.5
Terms of trade	-3.5	-12.3	-11.3	1.3	-5.1
Gov't budget balance % of GDP	0.3	0.3	0.3	-5.0	-5.1
Reserve money growth	16.3	-12.2	-12.5	1.2	16.5
Balance of Payments-US$ billion					
Exports, f.o.b.	124.6	130.0	138.6	131.6	133.7
Imports, f.o.b.	-129.1	-144.9	-141.8	-89.1	-98.5
Current Acct. Balance	-8.5	-23.0	-8.2	39.5	22.0
Usable reserves-eop	28.5	29.4	9.1	45.6	55.0
External Debt-Total-US$ billion	119.7	157.5	154.4	147.9	131.9
of which Short-term	78.7	100.0	68.4	35.3	31.7
External Debt-% of GDP	26.4	32.5	34.9	49.7	39.7
Debt-service ratio (MLT debt)	-	7.6	8.9	12.9	16.1

Source: IMF

15. The most significant achievement in the immediate term was avoiding default. In addition, the rollover ratio increased, signaling that interventions had begun to restore confidence and that the probability of future default had declined. The short-term debt restructuring of $24 billion with creditor banks in New York in January 1998 lengthened maturities to 1 to 3 years, buying additional time for structural reform measures to be implemented.

Structural Reforms

16. The Government made significant progress on all major fronts associated with the ERL as the following summary of actions shows. The vast majority of these actions was passed in a special session of the National Assembly on February 14, 1998, and constituted prior actions for SAL I. (SAL I continued to expand and deepen these reforms)

1. Macroeconomic

17. The macroeconomic framework was agreed with the IMF, which oversees benchmarks in this area.

2. Financial

18. During the period of ERL implementation, the underlying insolvency of the financial system became more apparent to government. Its efforts on the financial system were therefore focused almost entirely on priority tasks relating to dealing with insolvent and illiquid financial institutions. Medium term issues were in many cases deferred, generally with the concurrence of the Bank.

19. **Workout Program**. The incoming government took steps to tackle the crisis by assigning responsibility for dealing with financial distress to the Financial Supervisory Commission (FSC), the FSS oversight body that was to become operational on April 1, 1998. Prior to that, responsibility rested principally with the General-Secretary of the Presidential transition team (Joint Presidential Task Force), who later became the Chairman of the FSC. Under ERL, two major distressed commercial banks (Korea First Bank and Seoul Bank) were nationalized and preparations begun for sale to international financial institutions. The majority of the distressed merchant banks were closed (12 by March 1998, eventually 16). GOK provided support to all commercial banks via the purchase of non-performing loans by KAMCO, and the purchase by government-controlled investment funds of subordinated debt issued by the banks.

- GOK assumed control of Korea First Bank and Seoul Bank, wrote down existing shareholders' stake in the two banks to around 7 percent of their original stake and injected new capital (although, ultimately, insufficient to restore capital adequacy). Outside experts were hired in early 1998 to assess asset quality and perform diagnostic audits. Investment banks were invited to develop privatization strategy for these two banks. An investment banking firm was chosen in April 1998and the date for the implementation of the strategy was set under SAL II for first Spring 1999.

- GOK suspended the operations of 14 merchant banks in December and called for rehabilitation plans of all merchant banks. Following a first round of review by an independent evaluation committee, GOK revoked the licenses and ordered the closure of 10 merchant banks in early February. A "bridge" merchant bank was established to pay out depositors and dispose of assets of the closed banks.

- Public support was provided to potentially viable banks to strengthen their balance sheets. KAMCO purchased an estimated half of impaired loans at a discount to face value, though it was later realized that the amount of impaired loans had been underestimated. The Government subscribed to subordinated debt issued by commercial banks (to raise capital ratios by 1-2 percentage points).

20. **Supervision Framework**. GOK enacted legislation to consolidate, effective January 4, 1999, the pre-existing four supervisory agencies into the FSS reporting to the Prime Minister. The FSC was established and became operational, on schedule on April 1, 1998. Under ERL, GOK began making plans to commission diagnostic reviews by third parties of all banks, designed in part to test the adequacy of loan loss provisioning. Full-scale supervisory training was essentially deferred pending the merger of the agencies. At the writing of this ICR a consulting firm is being contracted to strengthen training programs as part of a broader set of tasks.

- The newly enacted supervisory structure consolidated various supervisory functions—covering banks, non-bank financial institutions and capital markets—in one body under the direct supervision of the Prime Minister's Office. The powers of supervisory authorities to intervene in and resolve troubled financial institutions were clarified and enhanced.

21. **Strengthening the Financial Sector**. Policy loans through MOFE were stopped. Under the ERL, the government eliminated the restriction on foreign bank ownership of commercial and merchant banks (although there did not appear to be any foreign capital actually entering the system in the months immediately following ERL effectiveness). The various deposit insurance entities were consolidated into a new Korea Deposit Insurance Corporation (KDIC). KDIC became a key instrument for financing the resolution of insolvent financial institutions.

- The Bank of Korea Act was amended to provide for greater independence of the central bank in setting monetary and credit policy.

- To encourage foreign investment in domestic financial institutions, the four percent limit on individual foreign ownership in any commercial bank was abolished. The purchase of bank equity by a single foreign bank is now permitted without limit, but requires approval at three stages: 10, 15 and 33 percent.

22. **Develop Competitive Financial System**. The medium term objectives outlined under ERL, and further developed under subsequent SALs, were to increase competition between banks, insurance and securities industries, review legal framework for non-bank intermediaries and eliminate barriers to competition, explore measures to promote institutional investing, define strategy for public asset and liability management, and reduce foreign barriers to entry in domestic financial markets.

- The Government has bound itself under the WTO financial services agreement to the financial services liberalization measures agreed earlier with the OECD.

    - The Government liberalized capital markets including: fully opening to foreign investors the domestic bond market and money market instruments issued by non-financial institutions; raising the aggregate limit on foreign investment in equities of listed firms from 26 to 55 percent (subsequently lifted altogether); and eliminating restrictions on corporate foreign borrowing with longer maturities.

3. Corporate Governance

23. Inclusion of corporate governance as a reform component demonstrated that the Bank recognized that the crisis was not merely a foreign currency crisis, but had deeper structural causes in the real economy. In the immediate term, the most important achievement was the progress made in financial disclosure, which is a prerequisite to meaningful corporate reform. This progress won back some lost confidence in the external financial sector and showed GOK's willingness and potential to impose a higher level of transparency required by regulatory authorities. In the short to medium term, the strategy was to show by the example of best international practices how Korean corporations could improve in the area of roles and

responsibilities of Boards of Directors and in credible performance of external audits. Specific measures taken in the area of corporate governance include the following.

Strengthened role of directors of companies

- Securities Exchange Act: strengthens minority shareholders' rights by lowering the threshold for exercising those rights, for example for filing a shareholders' representative suit from 1 to 0.05 percent of outstanding shares, and for inspection rights from 3 to 1 percent. Liberalizes M&As by eliminating mandatory tender offer requirements, and raising the ceiling for stock repurchase from 10 percent to 33 percent. Listed companies will be required to have at least one outside director.

Improved financial disclosure

- External Audit of Joint Stock Corporations Act: accelerates introduction of consolidated financial statements for corporate groups from the year 2000 to 1999, and requires an audit selection committee for listed companies and affiliates of large business groups.
- Composition Act: strengthens implementation process by introducing an administrator of asset preservation, imposing on debtors the obligation to report on implementation, and requiring evaluation of debtors' implementation by creditors.

Strengthened capital markets

- Bank Act: increases the ceiling on bank ownership of other firms' equity from 10 percent to 15 percent, or higher subject to FSC approval.

24. In general, some key corporate reforms were made quickly. Roles of key players were clarified, GOK accepted international accounting and audit standards (by 1999 instead of 2000), and the strengthening of the rights of minority shareholders was accelerated.

4. Competition Policy

25. There have been significant measures promoting competition policy, but action was weak with respect to the application of the FTA. The GOK could have done much more in supporting the FTA in terms of policy statements. It would have been especially effective if the KFTC's audit capability were given real strength. Currently, the KFTC cannot even gain access to important documents needed for audit. Therefore, it cannot carry out the necessary investigative role. Pre-merger notification is another important element of competition reform. The KFTC can evaluate the allowability of a corporate merger only after the merger has taken place, greatly reducing the likelihood of a challenge. The FTA could also be empowered to eliminate private restrictions to entry and exit such as the requirement of trade association membership. Another measure to reduce market concentration is that corporate asset sales be held publicly, not secretly or through swaps among the chaebols. Allowing unfriendly takeovers would serve also to increase competition and eliminate inefficiencies in the corporate sector.

Measures to facilitate entry and exit

- Foreign Direct Investment and Foreign Capital Inducement Act: permits takeovers of non-strategic companies by foreign investors without government approval, and raises the foreign stock ownership ceiling without approval by the Board of Directors from 10 percent to 33 percent.
- Bankruptcy Act: concentrates in district courts the authority over involuntary bankruptcy and composition and reorganization procedures that was formerly divided.
- Reorganization Act: expedites the process by setting deadlines, promoting courts' expertise by creating an administrative body, and enhancing creditors' role by creating a creditors' committee.

Measures to promote competition

- Corporation Tax Act: advances removal of the tax exemption regarding interest costs of excessive borrowings as losses and expenses from year 2002 to 2000.
- Tax Exemption and Reduction Control Act: provides tax breaks for restructuring of firms, including exemption of SMEs from capital gains tax on sale of real estate used to repay debt to financial institutions, and on transfers of real estate through M&A.

Measures to promote transparency

- Antitrust and Fair Trade Act: prohibits any new cross debt guarantees and eliminates all existing cross debt guarantees by the end of March, 2000.

5. Labor Markets/Social Safety Nets

26. The two keys to labor aspects of reform are the ability to make lay-offs and to provide safety net income to the unemployed. In February 1998, following SAL I negotiations, GOK and employers' and workers' representatives repealed a suspension on worker dismissals under the Labor Standards Act of March 1997. Resulting layoffs will facilitate structural change and ease the pent-up unemployment that was estimated to have climbed to 20 percent in medium technology sectors and 40 percent in lower technology companies. GOK is also laying the groundwork for safety net measures by improving the information base for poverty monitoring and targeting and by committing to a new non-contributory, means-tested social pension for the elderly (65 and older).

Measures to promote labor market flexibility

- Labor Standards Act: legalizes layoffs under M&As and to avoid financial difficulties.
- Manpower Leasing Act: introduces manpower leasing services for selected jobs requiring professional knowledge, skills and experience.
- Trade Union and Labor Relations Adjustment Act: notification of trade unions will be handled by local governments.

Measures to ease the social costs of adjustment

- Basic Employment Policy Act: authorizes the Ministry of Labor to implement unemployment measures, including vocational training to promote employment and financial support to cover living costs and medical care costs for the unemployed.
- Employment Insurance Act: reduces minimum contribution period from 12 to 6 months temporarily until June 30, 1999; increases minimum duration of benefit period to 60 days and minimum amount of Job Search Allowance from 50 to 70 percent of minimum wage.
- Wage Bond Guarantee Fund Act: entitles those laid off at bankrupt firms with more than five workers to a sum equal to three months' pay from a state-managed compensation fund from July 1.

27. In summary, the objectives of ERL were largely accomplished. The performance of the ERL should also be viewed as part of a broader longer-term series of efforts to stabilize the Korean economy and return it to a path of sustainable growth. The ERL was the first loan in a series of planned structural adjustment loans dealing with major aspects of the crisis. ERL implementation supported preparation of the second loan, the first structural adjustment operation (SAL I, loan amount - $2 billion, effective March 27, 1998), which placed more specific conditionality on the reform framework. The third loan, SAL II ($2 billion), is a two-tranche operation and became effective in October 23, 1998. Preparation of a fourth loan is dependent on Korea's needs after implementation of SAL II.

C. Implementation Record and Major Factors Affecting the Project

28. In December 1997, the Bank, along with the IMF and the ADB and bi-lateral donors, agreed with the Government to support a program of financial and economic stabilization and structural reforms. Lending was prepared and negotiated by the Bank on a highly accelerated basis in mid-December 1997. The ERL was declared effective on December 23, 1997 and the entire $3 billion was disbursed in one transaction on the same day. The ERL closed on February 28, 1998.

29. Leading up to the crisis, the Bank was not conducting economic and sector work on Korea as it would in the case of an active borrower. Because the crisis also developed suddenly, there was not time to design the ERL based on a comprehensive data analysis, nor develop detailed conditionality. Rather, it was derived mainly from still intact staff expertise on Korea and their priors about the Korean economy, as well as sector and financial distress expertise gained from countries which had earlier succumbed to the Asian Crisis.

30. Because of the unusual nature of the loan, it was debated whether this type of loan was justifiable under the Bank's Articles of Agreement. In the preamble to the Loan Agreement (B), the Bank's authority to make the ERL was described as follows: "under its Articles of Agreement as interpreted by the Executive Directors of the Bank in 1946, the Bank may, in special circumstances, make loans for programs of economic reconstruction and reconstruction of monetary systems, including long-term stabilization loans." In addition, the Bank's legal department presented as a basis for lending "the lender of last resort" concept (November 29, 1997 memo from I.F.I. Shihata to James Wolfensohn). The Bank was "satisfied that in the prevailing market conditions the Borrower would be unable otherwise to obtain the loan under

conditions which in the opinion of the Bank are reasonable for the Borrower." The cases of Gabon and Venezuela were also cited as countries which had graduated, but had encountered economic difficulties, including, but not limited to, declines in GNP per capita, and had resumed borrowing from the Bank

31. Although the ERL was not a standard loan, its approval was not approval of a new general product line. The ERL had not only a legal basis, but an actual precedent as well. An ERL had been given to France in 1947. The precedent was that a loan was given to a country where no economic and sector work or country assistance strategy had been done. Although the contexts were very different, the precedent eased concern that a new product line was being approved.

32. **Factors not generally subject to Government's control.** Korea was disadvantaged in that its crisis occurred after the crises in Thailand, Indonesia and Malaysia. Investor confidence in the region was already severely shaken. G-7 countries faced domestic resistance to another bailout, this one to be the largest in the series. There were also signs prior to the actual crisis that the Korean economy was in a downswing with slowing export growth, declining terms of trade, and emerging corporate and financial sector distress.

33. The crisis occurred also in the midst of a national election campaign. The election was held on December 19. One week before, the opposition candidate waged a vigorous attack on the $57 billion support package. When the new government was elected, however, it fully embraced the reform framework. The transition period went reasonably well and SAL I was prepared and approved.

34. It turned out that the victory by the opposition government was an advantage to the reform program. The opposition won on a platform of change and reform, notwithstanding some of the rhetoric of the campaign. The new government was receptive, for example, to pro-competition policies, a culture not well-developed in the Korean economy.

35. Another factor operating in Korea's favor, in terms of regaining financial sector confidence, was its reputation as a model of economic performance. For several decades, it had been a low inflation, low unemployment, high growth, budget surplus, low public debt country. If the crisis could be defused, and a solid reform program adopted, investor confidence could be restored relatively quickly. Korea also benefited from a strong endowment of human capital as well as a long track record of hard work and thrift.

36. **Factors generally subject to Government control.** Leading up to the crisis, the Government's flawed risk management of international debt and capital flows led to overexposure in short-term obligations that created the urgent liquidity crisis which was addressed by the ERL. Over a longer period, the Government also maintained an incentive regime with a strong element of moral hazard. This incentive regime rewarded conglomerates when economic times were good, but punished the financial sector, and, by extension, society as a whole, during less favorable economic conditions.

37. Other measures within the Government's control were laid out in the Letter of Development Policy for the ERL. The substantial progress made with respect to those factors is

detailed in Section B. This progress can be attributed, in part, to the urgent need to cooperate with the IMF/Bank reform package. The prior government also allowed Bank staff to brief opposition leaders during the election campaign. This policy enhanced acceptance of the reforms by the new government and provided for a more productive transition period. Both governments recognized the need for and were committed to reform and understood the economic principles behind the reform. The reform effort also benefited from Korea's relatively advanced level of development because there was a good store of expertise on the Korean economy outside the government that also made substantive contributions to the policy dialogue.

38. **Factors generally subject to implementing agency control**. The BOK's and MOFE's responses were good. Both contributed to rapid progress in estimating Korea's immediate liquidity needs. The overall size of the support package could be determined from these estimates. The availability of economic and financial data was reasonably good, which facilitated an early assessment of the extent of the crisis. The teams from both agencies worked assiduously with Bank and IMF staff during a politically tumultuous period. MOFE played a key role in coordinating reforms that cut across government agencies.

D. Project Sustainability

39. Without meaningful restructuring, further collapse would only be postponed. The outline of reforms laid out in the ERL is considered sustainable, first, because this framework identified areas widely acknowledged to be the sources, not just the symptoms, of Korea's economic crisis, and, second, because of the numerous key reforms and commitments that were made (Section B.). The areas of reform were accepted by both the previous and new governments and two subsequent SALs have been implemented which included specific conditions relevant to the ERL. Fragile investor confidence still threatened the recovery, but, for the short-term, default was averted. Early incorporation of social safety net measures has helped ease opposition to the more painful elements of the reform program. The establishment of the committee representing business, government and labor interests was also valuable in gaining support for the ERL reform framework. A new Korea country unit was established at the Bank in January 1998 to support both of ERL and subsequent loan program sustainability. To facilitate close interaction with the client, the new country unit's director was stationed in Seoul. The SFO unit, also recently established (February 1998), has worked to develop and sustain a program of financial sector reforms in Korea.

40. Despite some slippages in macroeconomic indicators and structural policy reforms, overall progress in implementing the objectives of ERL has been satisfactory. Subsequent planned operations (see section H.) support a continued process of stabilization and structural reform that emphasize deeper financial and corporate sector reforms and mitigation of the social side affects of adjustment.

E. Bank Performance

41. This section reviews critiques of Bank performance on the basis of what was a reasonable standard at the time and what would have been the best course in retrospect. Generally speaking,

the Bank did respond quickly and substantially once massive default appeared inevitable. With the GOK and IMF, it engineered a credible reform framework for subsequent lending. The Bank also navigated through an extremely difficult situation in which a top performing economy with internationally recognized companies found itself, in a short time span, near collapse. Designing a program of deep and far reaching reforms and applying them to what was one of the Bank's greatest success stories was a difficult challenge for Bank staff and management.

- The Bank, as well as the Korean authorities, should have more closely tracked events leading up to the crisis and better guaged its severity. The late recognition of the crisis brought Korea dangerously close to default and meant that the ERL had to be prepared on an overly compressed timetable.

  There is no documentation to suggest that the Bank (or the IMF) anticipated the Korean economic crisis or its depth. The mitigating circumstance is that Korea had graduated from Bank borrowing in FY1995, there were few Bank funded activities (although there was a financial sector intermediation loan which was winding down), and almost no Bank staff working on Korea. The manpower to do economic and sector work and specifically monitor the Korean financial and corporate sectors was, therefore, not in place. Valuable time was lost with Korea's delayed request for assistance from the Bank (and IMF). Because default was imminent, the Bank and the IMF had to work extremely quickly to design an operation that would allow the emergency transfer of liquidity. Despite the time pressure, relevant areas of reform were agreed.

- The Bank customized the operation to meet urgent needs

  Because of the uniqueness of the ERL and the involvement of very senior Bank management, the normal loan process could be greatly accelerated to conform to the exigencies of the crisis. A team with appropriate expertise was quickly recruited. There was no concept paper, nor regional operating committee review. Furthermore, the loan amount and terms were not determined until Board presentation when Korea's and the Bank's needs were more clearly assessed.

- The Bank might have been more involved at the beginning in the GOK/IMF discussions

  Initial negotiations on the broad framework for recovery were conducted by the IMF. The result was that the Bank inherited some features of a reform program that might have benefitted in design from Bank expertise had the Bank been more involved at the outset. For instance, the Bank could have contributed to the policy discussion regarding labor markets/social safety nets. In addition, the GOK would not have been subjected to repetitious discussion of the macro framework. In reality, the IMF was far more geared up to intervene in Korea than was the Bank. During the crisis, response time was counted in days rather than weeks or months. That the IMF negotiated a week before Bank arrival was to be expected and was valuable to the Bank, because the IMF had already collected and analyzed data essential to the reform package (e.g., monetary aggregates, growth projections). The Bank and the IMF soon agreed on areas of collaboration and division of labor.

- The Bank, with the Fund, modified an initially ineffective rescue package to one that ultimately eased the concerns of international financial markets

  The IMF's $57 billion package announced on December 4 was inadequate because it lacked sufficiently rapid phasing to deal with Korea's immediate liquidity demands.[2] Frontloading was necessary to avoid default. The Bank committed to frontloading in an unprecedented way by increasing its initial disbursement from $2 to $3 billion. This move demonstrated Bank resolve and may have encouraged G-7 countries, referred to as the second line of defense, also to frontload their support in the package. The announcement of the frontloading of both multilateral and bilateral support calmed the markets. G-7 countries also helped by influencing private banks to rollover Korea's debt ($24 billion of short-term debt due in the first quarter of 1998) and lengthen its maturity. The frontloading and support for debt restructuring apparently provided the missing elements the financial markets were looking for because the rollover ratio for Korea's short-term debt improved markedly after the announcement.

  It is argued that saving $1-2 two billion for future lending (out of the $3 billion ERL) would have meant substantially greater support for specific conditions of a longer term reform program. In the emergency conditions in December 1997, it was concluded, however, that it was best to minimize default risk and avoid potentially much greater damage to the economy.

- The Bank could have negotiated more effectively with the GOK to drive through a more specific reform program which would have made SAL negotiations easier and more productive.

  After the ERL disbursed and the Korean economy began to stabilize, the powerful chaebols, for example, were able to regroup and muster greater resistance in the reform dialogs leading up to SAL I and SAL II. The policy dialog was also delegated to lower level officials in the Government, who moved more slowly. Thus, it is probable that, despite the extremely tight timetable for loan processing, more policy reform commitments could have been obtained that would have smoothed the way for subsequent policy negotiations. Still, in pressing for additional commitments, the negative effects of possible delays had to be weighed.

- There was insufficient guidance from headquarters to the field team in designing and negotiating the ERL.

  The field team would have benefited from clearer guidance on which issues headquarters wanted to take a firm stance and where it was more flexible. Earlier determination on loan pricing would also have helped. However, because the crisis hit suddenly, the Bank needed time to reassess the impact on the Bank's overall lending before it could give final lending terms. Actual damage done was probably minimal, but processing would have flowed more smoothly and morale would have been kept higher.

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2 Inefficacy of the package also had to do with the revised debt picture which showed the crisis to be worse than originally thought.

- The costs of preparing and implementing the ERL were very high

  The ERL costs include: (a) an overall effort to staff up a unit to deal with the crisis; (b) mobilizing a general advisory SWAT team; and (c) preparation of other loans in the sequence of program lending. Costs are estimated at over $490,000, higher than for similar operations, assuming that the other activities have been properly separated, but reasonable when compared to the amount of the loan and the income generated from the loan. Costs were controlled to some extent by the highly compressed processing timetable. When recognizing that the Bank's Korea unit had to be geared up, the somewhat higher costs were acceptable.

42. In summary, although the Bank was not able to anticipate the crisis, it demonstrated, along with other lenders, a swift response in accelerating balance of payments assistance. On an extremely compressed timetable, the Bank, with the Government and other donors, identified several large operations to address major areas of stabilization and structural reform over a two to three-year period. The Bank consistently held its position that a Government plan for effective macro-economic stabilization and medium-term structural reform framework were essential conditions for Board presentation of ERL and closely monitored the measures in the policy matrix.

F. Borrower Performance

43. As measured by its commitment to a wide ranging reform agenda, Government performance is considered satisfactory. The Government committed to a set of reforms in its Letter of Development Policy emphasizing financial sector restructuring and accomplished almost all of its policy initiatives specified under the objectives of the loan. The ERL laid the ground for a deeper and more specific set of reforms under subsequent SALs. To carry out these policy initiatives, GOK committed to a heavy legislative agenda and held special sessions of the National Assembly. The newly elected government firmly supported the program during the transition period leading up to its taking office on February 25, 1998. GOK made good early progress in improving disclosure in the financial sector, the sine qua non of successful reform. This was a difficult step because of the powerful chaebols linked to the troubled financial institutions.

44. BOK, on behalf of the Government, maintained the accounts for the ERL in accordance with sound accounting practices. It was agreed that the program would be audited within four months of Bank request. Government compliance with legal covenants under ERL was considered satisfactory.

G. Assessment of Outcome

5. The overall performance and outcome of the ERL was satisfactory, as the identified areas for medium term policy measures was shown to be relevant as evidenced by subsequent SAL conditions which deepened the reform program. The ERL was also successful as part of the total

rescue package, because Korea averted default. This rating is consistent with the rating by EASPR of meeting development objectives (Form 590) at project close (also Satisfactory). Because it was not an investment operation, calculation of benefits in terms of net present value and economic rates of return is not applicable.

H. Future Operations

46. The first Structural Adjustment Loan (SAL I) was the immediate follow-up operation, effective March 27, 1998. SAL I ($2 billion) supported Government efforts to deepen structural reform in the financial sector, corporate sector and social sectors. The next loan (SAL II) was a two tranche, $2 billion operation building on SAL I. SAL III is planned for FY2000.

I. Key Lessons Learned

47. Because of the special features of the ERL, the lessons learned are far reaching and go to the core of the Bank's mission. The main lessons learned are:

- **Maintaining a knowledge base**. The Bank should maintain access to a cadre of high level expertise that has dealt with occurrences of systemic financial corporate distress, whether accessed externally or maintained in-house. The Bank's stock of experience on Korea and on emergencies in the corporate sector had dwindled to a very low level by the time of the Korean crisis. Assembling a capable team was a very ad hoc exercise. Establishing the SFO, mostly from existing staff, did establish a capacity to assist a small number of countries already in financial distress, but not to anticipate financial crises.

- **Use of non-government resources**. In-country expertise outside of government can be very useful in diagnosing economic problems, especially where there are large gaps in the Bank's knowledge or that knowledge is out of date. The Bank team made (and continues to make) good use of Korean think tanks, universities and NGOs to supplement its knowledge base in drafting the ERL.

- **Maximize negotiation results during crises**. Care should be taken to achieve maximum negotiation results when a country faces an emergency. It is much easier to obtain agreement on reforms at that time. Because the economic crisis was so severe, the Bank and IMF were negotiating at the highest levels of the GOK where it is also easier to reach agreement quickly. Once stabilization measures begin to work, pressure is eased and motivation for reform lessens. In this crisis, the Bank did use Korea's urgent liquidity needs to secure commitment to an indicative outline of reforms. Achievement of additional conditionality and benchmarks should be guided by the trade-off between negotiating results and possible delays that could jeopardize the effectiveness of the program (in this case, the timely delivery of liquidity).

- **Consultative approach to reforms**. Creating a forum of Government, labor and business leaders for the purpose of achieving consensus on reforms affecting these three major groups is an effective vehicle to gain support for economic reforms.

- **Disclosure/transparency.** An essential initial step in resolving problems in the corporate sector is disclosure. It is the sine qua non of subsequent reforms, as well as making accurate credit assessments and regaining the confidence of foreign lenders.

- **Need for explicit competition reforms.** The ERL contained an explicitly stated, discrete set of competition reforms as a basis for sustaining the reform program. A clear set of competition policies was important to Korea because of the rent-seeking, over-investing behavior of the chaebols that had led to the crisis. The Bank could make greater use of this practice of incorporating competition measures as part of its program of lending prescriptions. Reform packages are enhanced when they include competition policies in areas such as foreign ownership, supervision of banks, and corruption.

- **Crisis management tool.** The use of parallel teams, one in Korea and one in headquarters (the latter shepherding papers through by day), was an effective way to accelerate processing of the Korea ERL.

- **Accelerated processing for emergencies.** In emergency circumstances such as the Korean crisis, the Bank demonstrated the necessity of relaxing reporting requirements in order to respond quickly and so that expertise may be freed for more substantive analysis and creative solutions.

- **Management of portfolio risk.** The Bank has to have the capacity to systematically manage a shift in the risk of its portfolio. To assess risk adjustment for capital allocation in the ERL case, Bank staff had to improvise to find pricing that would appropriately account for the sudden change in the Bank's risk profile. At the time the Korean crisis hit, the Bank's financial policy department had begun to study ways to analyze and estimate risk-adjusted return on capital in the context of the Bank's capital adequacy requirement.

- **Inseparability of program design and loan terms.** Lending terms and substantive reform program design must be negotiated together. This was not the case for ERL. In fairness, the borrower should know early on the cost of capital attached to the reform program to which it is agreeing.

- **Single tranche approach.** A single tranche policy-based operation (such as ERL), with the framework for policy actions clearly laid out prior to Board approval, was an effective vehicle for rapid liquidity transfer. Follow-up SALs restore leverage to the Bank in reform negotiations after the previous loan is disbursed.

- **Need for stronger commitment with regionalized crises.** When a crisis is regionalized, positive results from reforms may be slower to be realized. Investor confidence is more difficult to restore as well as growth in aggregate demand. The Government and the Bank had to demonstrate greater resolve in adhering to the reform program.

- **Consistency with the Bank's business.** The Bank should adhere to a clear concept of what business it is in and be careful not to redefine its business according to the market opportunity. That the ERL provided emergency liquidity raised concern that the Bank was straying from its role as a development institution. This concern contributed to subsequent Bank policy in the form of special SALs.

STATISTICAL TABLES

Table 1: Summary of Assessments

A. Achievement of objectives	Substantial	Partial	Negligible	Not Applicable
Macro policies	[X]	[ ]	[ ]	[ ]
Sector policies	[X]	[ ]	[ ]	[ ]
Financial objectives	[ ]	[X]	[ ]	[ ]
Institutional development	[ ]	[ ]	[ ]	[X]
Physical objectives	[ ]	[ ]	[ ]	[X]
Poverty reduction	[ ]	[ ]	[ ]	[X]
Gender issues	[ ]	[ ]	[ ]	[X]
Other social objectives	[ ]	[X]	[ ]	[ ]
Environmental objectives	[ ]	[ ]	[ ]	[X]
Public sector management	[ ]	[X]	[ ]	[ ]
Private sector development	[ ]	[X]	[ ]	[ ]
Other (specify)	[ ]	[ ]	[ ]	[X]

B. Project sustainability	Likely	Unlikely	Uncertain
	[X]	[ ]	[ ]

C. Bank Performance	Highly Satisfactory	Satisfactory	Deficient
Identification	[ ]	[X]	[ ]
Preparation assistance	[ ]	[X]	[ ]
Appraisal	[ ]	[X]	[ ]
Supervision	[ ]	[X]	[ ]

D. Borrower performance	Highly Satisfactory	Satisfactory	Deficient
Preparation	[ ]	[X]	[ ]
Implementation	[ ]	[X]	[ ]
Covenant compliance	[ ]	[X]	[ ]

E. Assessment of outcome	Highly Satisfactory	Satisfactory	Unsatisfactory	Highly Unsatisfactory
	[ ]	[X]	[ ]	[ ]

Table 2: Related Bank Loans

Loan Title	Purpose	Year of Approval	Status
Preceding Operations			
1. Financial Intermediation Loan	Provide TA to the Government and BOK to Develop a Program of Structural Reform in the Financial Sector	FY94	Closed
Following Operations			
1. Structural Adjustment Loan I	Immediate foreign exchange assistanceand establishing conditionality for areas of ERL: financial sector restructuring, corporate governance, competition, labor market and safety nets, and institutional reform in economic policy management and consistency with macroeconomic framework agreed with the IMF.	FY98	Closed
2. Structural Adjustment Loan II	Deepen structural reforms in the financial sector, the corporate sector and labor market and social safety nets as well as macroeconomic policies to mitigate the recession and consolidate progress in strengthening the external financial position, consistent with IMF agreement.	FY99	Under implementation

Table 3: Project Timetable

Steps in Project Circle	Date planned	Date actual/ latest estimate
Identification		N/A
Preparation/Appraisal		12/4-14/97
Negotiations		12/16-18/97
Letter of development policy (if applicable)		12/97
Board presentation		12/23/97
Signing		12/23/97
Effectiveness		12/23/97
Full Loan Disbursement		12/23/97
Midterm review (if applicable)		N/A
Loan closing		06/30/98

Table 4: Loan Disbursements: Cumulative Estimated and Actual (US$ thousands)

IBRD Fiscal Year	Appraisal Estimate	Actual	Cumulative Actual	Actual As Percentage of Estimate
	(US$ thousands)			
1998	N/A	3,000,000	3,000,000	N/A

Date of Last Disbursement: December 23, 1997

Table 5: Key Indicators for Project Implementation

	Estimated	Actual
I. Key implementation indicators in SAR, Modified,etc.		
For all indicators, see *Matrix of Policy Actions*-Appendix B)		

Table 6: Key Indicators for Project Operation

	Estimated	Actual
I. Key operating indicators in SAR, Modified, etc.		
For all indicators, see *Matrix of Policy Actions*-Appendix B)		

Table 7: Studies Included in Project

Study	Purpose as defined at appraisal	Status	Impact of study
1.	NO STUDIES INCLUDED		

Table 8A: Project Costs

Item	Appraisal estimate (US$ million)			Actual (US$ million)		
	Local costs	Foreign Costs	Total	Local costs	Foreign costs	Total
1. Emergency Liquidity Assistance		3,000	3,000		3,000	3,000
Total		3,000	3,000		3,000	3,000

Table 8B: Project Financing

Source	Appraisal estimate (US$ million)			Actual/latest estimates (US$ million)		
	Local costs	Foreign costs	Total	Local costs	Foreign costs	Total
1. IBRD/IDA		3,000	3,000	0	3,000	3,000
Total		3,000	3,000	0	3,000	3,000

Table 9: Economic Costs and Benefits

N/A

Table 10: Status of Legal Covenants

Agreement	Section	Covenant Type	PresentS tatus	Original Fulfillment Date	Revised Fulfillment Date	Description of Covenant	Comments
Loan	3.02 (b)	1	NC	10/30/98	10/30/98	Audit of Deposit Account	Audit report not yet requested by the Bank.

Covenant type:

1 = Accounts/audits
2 = Financial performance/revenue generation from beneficiaries
3 = Flow and utilization of project funds
4 = Counterpart funding
5 = Management aspects of the project or executing agency
6 = Environmental covenants
7 = Involuntary resettlement
8 = Indigenous people
9 = Monitoring, review, and reporting
10 = Project implementation not covered by categories 1-9
11 = Sectoral or cross-sectoral budgetary or other resource allocation
12 = Sectoral or cross-sectoral policy/regulatory/institutional action
13 = Other

Present Status

C = covenant complied with
CD = complied with after delay
CP = complied with partially
NC = not complied with

Table 11: Compliance with Operational Manual Statements

Statement number and title	Describe and comment on lack of compliance
FULL COMPLIANCE	

Table 12: Bank Resources: Staff Inputs

Stage of project cycle	Planned		Revised		Actual	
	Weeks	US$	Weeks	US$	Weeks	US$
Preparation	9.9	31.4			12.1	39.0
Appraisal	14.5	64.8			13.1	59.4
Negotiations	14.5	41.3			7.3	12.7
Supervision	104.1	323.3			115.7	373.5
ICR	2.5	7.0			0.5	1.0
Total	145.5	467.8			148.7	485.6

Table 13: Bank Resources: Missions

Stage of project cycle	Month/Year	No. of Persons	Days in Field	Specialization [1]	Performance Rating [2]		Types of Problems [3]
					Implementation status	Development objectives	
Preparation through Supervision	12/97-2/98	25	266	E,F	N/A	N/A	
otal		25	266	E,F			

1 - Specialization

= Economist
= Financial Analyst
= Energy Specialist

2 - Performance Rating

= Minor problems
= Moderate Problems
= Major Problems

3 - Types of Problems

= Financial
= Technical
= Managerial
P = Political

ANNEX A

BORROWER'S CONTRIBUTION

TO THE ICR

Borrower Contribution to the ICR (Implementation Completion Report)
ERL (Economic Reconstruction Loan)

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1. Korea Financial Crisis

The imminent cause of the Korean financial crisis that erupted in late 1997 was the near depletion of foreign currency reserves. Nonetheless, the latent structure of the crisis owes to other more fundamental factors. Domestic origin of the crisis can be tracked back to long-standing structural weakness of the Korean economy, although one should acknowledge the exogenous effects of the epidemics of the Southeast Asian crisis. Korea's failure to keep up with the rapid pace of globalization was one main reason that eventually invited the crisis. Korea was ill-prepared for the changes in the global economic environment. The country's over-exposure to short-term external debt made it particularly vulnerable to cyclical shocks as well as changes in market expectations. The Korean economy has long been plagued by pervasive moral hazard problems. Under the umbrella of government protection, financial institutions indulged in questionable lending practices. Yet for every reckless lender, there has also been a reckless borrower. One immediate impact was the sharp loss of investor confidence. In fact, abrupt outflow of short-term foreign portfolio investment between September and November 1997 initiated the sudden capital flight and the currency rumble. The won plunged 27.5 percent against the U.S. dollar in November 1997, and lost 40.3 percent of its value from a year ago in December 1997. Under such circumstances, it was inevitable for the Korean government to seek assistance from the international community, including the World Bank.

2. Introduction of ERL

The $3 billion Economic Reconstruction Loan (ERL) was the first loan which the Bank resumed after Korea's graduation from Bank borrowing in 1995 and greatly contributed in solving the emergency liquidity problem in Korea. Notwithstanding difficulties arising from situational imperativeness and little experience of both sides, the Korean government and the Bank closely cooperated in forging out policy measures for Korea's structural reforms, which laid the basis for a series of reform programs of leading up to SAL I and SAL II. While the IMF focused on the macroeconomic stabilization, the Bank paid more attention to the economic structural reforms in corporate and financial sectors and etc. The Korean government agreed with the Bank on the importance of the economic structural reforms and its firm commitment was well reflected in the policy matrix of ERL.

3. Policy Responses from the Korean Government

The new Kim Dae-Jung administration in Korea showed tremendous resolve and leadership in overcoming the financial crisis. Even before officially taking office. President Kim and his advisors worked with the outgoing administration to establish the Emergency Economic Policy Coordinating Committee. The Committee took a number of decisive actions that helped to restore the confidence of the international community in Korea's economic policies. Under President Kim's strong leadership, the Korean government faithfully implemented the World Bank and the IMF program, oftentimes going beyond the measures required by those institutions. As a result, not only has Korea's international credibility been restored, successful reform measures, in fact, have helped put the Korean economy back on track for positive growth.

4. A Few Lessons from the ERL

A few lessons should be noted from Korea's experience with the ERL with an aim to increase the efficiency of such programs in the future.

First, it is most important that the world Bank programs are designed within an atmosphere of cooperation and goodwill so that they reflect the respective country's unique situation – its fiscal status, industrial structure and social system. The more a country in distress worries about the measures the Bank program may impose, the more hesitant it will become to seek Bank assistance. In any case, a closer tailoring of individual programs will minimize unexpected economic side effects resulting from the Bank Programs. Second, when a country enters into negotiations on conditionalities with the assisting institutions, the World Bank, the IMF, and the regional IFI's should work together to better coordinate the conditionalities to be imposed on the country. Numerous renegotiations with various institutions result in inefficiency and excessive burden, and thus can weaken the program ownership in the borrower country. Finally, the Bank's staffs need to be more responsive to the policy demands of the borrower. It is more effective for the Bank to endorse the reform programs implemented by the country and facilitate their promotion in a desirable manner rather than focus on excessively ambitious targets in a specific sector.

5. Further Progress of Reform Efforts

The Korean government's economic policies will focus on full implementation of ongoing reforms which trace back to the agreed policy measures of ERL. At the same time, policy prudence will be exercised to counteract potential instability from overseas as well as domestic markets. The Korean government's economic policies are firmly rooted in the principle the democracy and market economy are interlocked concepts. In this sense, the government is firmly committed to full economic integration with the global economy for the country's long-term stability and prosperity. To this end, the Korean government will continue to accelerate its structural reform efforts in the future.

ANNEX B

MATRIX OF POLICY ACTIONS

MATRIX OF POLICY ACTIONS (MARCH 1998)

Objective	Policy Measure	Monitoring Indicators
1. **Macroeconomic Framework** Restoration of financial stability and resumption of robust, sustained growth	Sound management of macroeconomic policies--fiscal, monetary, debt management, exchange rate policies--within an agreed medium-term framework	Adherence to the agreed macroeconomic framework
2. **Financial Sector**		
2.1 Strengthening the Regulatory and Institutional Framework. Implement financial sector restructuring within a coherent, well-coordinated sector strategic framework.	* Endow the Special Task Force at MOFE (and its successor later at FSC) with adequate powers to coordinate the development and implementation of financial sector recapitalization and restructuring strategy, under mandate set in consultation with the Bank.	Task Force fully operational and actively carrying out its mandate.
	Develop an overall strategy for financial sector recapitalization and restructuring, with assistance of World Bank and other international expertise.	Strategy developed in consultation with the Bank. Issuance of written policies and guidelines on financial restructuring consistent with that strategy.
Strengthen the legal and institutional framework for the resolution of troubled financial institutions.	* Adopt legislation acceptable to Bank to give supervisory authorities increased power to intervene and resolve troubled institutions.	Law adopted.
	Adopt a resolution mechanism for insolvent financial institutions, including receivership procedures and policy on subsequent divestiture.	Insolvent institutions dealt with consistently and in accordance with well-defined procedures.
Improve the framework for troubled debt resolution.	Establish a framework to facilitate workouts between creditors and corporations.	Establishment of the workout framework and its transparent application to individual cases.
	Issue clear guidelines on the prudential and tax treatment of restructured debt.	Regulations issued and published.
Improve the regulatory framework.	* Announce timetable acceptable to Bank for upgrading bank accounting, auditing and reporting to international standards (see also Corporate Governance below).	Public issuance of regulatory accounting principles (RAP) and standards consistent with international best practice. Establishment of legal auditing responsibilities.
	* Announce a policy of requiring financial institutions to close books and report publicly on a quarterly basis at the earliest date possible.	Policy announced.

Objective	Policy Measure	Monitoring Indicators
	Improve and harmonize prudential and market practice regulations applicable to deposit-taking institutions. Tighten regulations relating to connected lending and accounting of trusts	Regulations for deposit-taking institutions (including merchant banks) harmonized. Rules on connected lending and trusts tightened.
Strengthen supervision.	As part of the process of establishment of FSC/FSB, and an institution- building strategy agreed with Bank, undertake in-depth review of foreign major-market supervisory and regulatory regimes integrating banking, securities and insurance supervision and adopt appropriate policies and procedures for risk-oriented supervision.	Institution-building strategy agreed with Bank. Report issued. TA in place for FSC/FSB. Policies and procedures issued.
Improve governance of banks and other financial institutions.	Review and improve governance structure of banks (including provisions relating to appointment, responsibilities and liabilities of directors and managers).	Necessary changes in laws, regulations and guidelines.
	* Confirm notification to banking industry of the Government policy of non-intervention in bank management, including the appointment or approval of directors and managers.	Adherence to such policy.
Further develop deposit insurance.	Implement the consolidation of the various deposit insurance schemes.	Adoption of appropriate guidelines, policies.
Increase foreign participation in banks and capital market, incl. M&As.	Accelerate removal of ceilings on foreign investment in banks, other financial institutions and listed companies.	Liberalization of foreign investment/ownership limits as agreed.
2.2 <u>Resolution of Merchant Banks</u> Clarify processes for evaluation and closure of merchant banks, ensuring only viable banks allowed to operate.	* Put in place the following to the satisfaction of the Bank: - Written instructions for due diligence review. - Arrangement of internationally recognized firms to conduct rehabilitation plan evaluations. - Adoption of standardized templates for review of rehabilitation plans and recommendations. - Application of clear standards and instructions to merchant bank evaluations, providing the basis for well-documented decisions on closure or continuation of operation.	Appropriate notification to merchant banks. Demonstrated integrity of rehabilitation plans.

Objective	Policy Measure	Monitoring Indicators
	- Establishment of a process to monitor conditionalities placed on merchant banks allowed to continue to operate, including capital adequacy thresholds.	
Require the merchant bank closure and asset transfer process to be conducted in a transparent and judicious manner.	* Implement the following actions to the satisfaction of the Bank: - Evaluate the legal basis for closure and asset transfer, and take steps procedurally and legislatively to address potential legal vulnerabilities. Legally establish the order of creditor repayment. - Clarify Bridge Bank's role as liquidator, asset manager, and deposit insurance paying agent. - Prepare procedures for revoking the license, closing the bank, physical control, inventory/due diligence, and asset valuation. If external bids allowed, establish when external bids will be accepted after license revocation. - Establish how funds realized from asset sales will be distributed.	Legal review, policies, procedures prepared.
	Close all unviable merchant banks. All surviving merchant banks to meet capital adequacy guidelines already agreed. Strengthen supervision policies and practices for those allowed to remain open.	Closure of unviable merchant banks by April 30.
2.3 <u>Resolution of Korea First Bank and Seoul Bank</u>. Complete the resolution of these two banks.	Hire internationally recognized advisors on TOR acceptable to the Bank to develop strategy for privatizing these two banks.	Contract with advisors by March 31.
	Send out notification to internationally recognized investment banks for assistance in the privatization and sale of these banks on TOR acceptable to Bank.	Contract with investment banks by March 31.
	Assess asset quality of these banks and perform diagnostic audits. Commit to particular strategy to privatize and sell (by Nov. 15). Undertake cost reduction plans, staff layoffs and management reconfiguration prior to sale. Further layoffs and reconfiguration allowed after sale. Commit not to inject new public funds in these banks after Jan. 31, except to maintain minimum liquidity to service	Issuance of notification inviting tenders for due diligence and external audits by internationally recognized firms.

Objective	Policy Measure	Monitoring Indicators
	liabilities. Bring in foreign investors who will provide expertise and capital inflow.	
2.4 Commercial Banks Improve the quality of data on commercial bank portfolios and assessment of capital adequacy.	Hire internationally recognized firms on TORs acceptable to Bank for external audits, including diagnostic reviews, of all commercial banks.	Contracts with firms by March 31.
	Intensive supervision of capital adequacy of all commercial banks (including validation of fixed asset valuation, and enforcement of improved provisioning and loan classification standards).	Evidence of application of new, stronger standards.
Assess viability of banks.	* Require that all banks not meeting BIS capital adequacy standards on 12/31/97 provide recapitalization and rehabilitation plans of sufficient scope and detail acceptable to Bank. Same condition to apply to those not meeting these standards on 6/30/98 and subsequent reporting dates.	Rehabilitation plans prepared.
Verify viability and take enforcement actions.	* Hire internationally recognized firms on TORs acceptable to Bank to assess recapitalization and rehabilitation plans.	Contracts with firms.
	Implement graduated enforcement policies (per new law). Close unviable banks.	Closure of unviable banks.
2.5 Transparency of Government Support. Appropriately record all public support to troubled financial institutions and corporates.	* Account for all past support to troubled financial institutions and corporates in a transparent manner, recording not only interest costs in the budget but also reflecting the stock of debt incurred by government and related agencies in the overall public debt figures. Provide a report on these estimates to the Bank. Continue this accounting practice.	Actual recording/reporting of public support in this manner in fiscal accounts and public debt figures.
Clarify procedures for public support.	* Announce policy that, with effect from the date of the policy announcement, KAMC and other agencies involved in government support will provide such support only as part of approved recapitalization/rehabilitation plans or liquidation.	Policy announced.
	It shall be government policy that KAMC will purchase assets at estimated market value, and that assets will be sold back to the	Policy announced.

Objective	Policy Measure	Monitoring Indicators
	private sector as rapidly as possible.	
Enforce sound principles for KAMC and Bridge Bank operations.	* Issue written procedures for KAMC and Bridge Bank operating process, internal control, transfer pricing, asset valuation, asset sales and bid process (where applicable) and governance. Regular disclosure of financial position, including an independent valuation of assets. External audits by internationally recognized firms. Capital and borrowing structure clarified and funding instruments standardized. Institutional capacity improved, including through inclusion of private sector in governance structure.	Procedures and guidelines issued. Implementation of these procedures and guidelines: financial reports, audits. Improvements in governance structure and technical capacity, including through use of TA.
2.6 Capital Markets Promote competition between different financial service providers to improve the efficiency of intermediation and spur the diversification and deepening of the financial system.	Review and harmonize regulatory regime for alternative providers of savings vehicles and their lending and investment policies to reduce financial market segmentation and barriers to competition.	Progress on harmonization of regulatory regime to reduce market segmentation.
Implement debt market reform conducive to more market-based determination of the interest rate/term structure and market deepening, including a lengthening of maturities.	* Establish a task force (including private sector experts as well as public authorities) to study policies to promote primary and secondary debt market. Regularize announcement of government securities. Standardize maturities and instruments while developing the longer end of the yield curve. Reduce auction of government bonds through obligatory purchases. Consider issuing KDIC bonds in the market including auction (instead of issuing to BOK). Explore possibilities of increasing issuance of T-bills to replace MSB currently issued by BOK. Improve bond market information, trading and clearing systems, and promote an active inter-dealer broker market.	Establishment of a task force. Primary and secondary market activity indicators.
Develop the equity market to reduce the gearing ratio of firms and broaden access to equity finance.	* Establish a task force to review appropriateness of current market configuration. Increase transparency of equity market regulations and reduce discretionary power of regulators. Liberalize IPO regulations while tightening requirements for	Task force established. Implementation of the indicated actions.

Objective	Policy Measure	Monitoring Indicators
	disclosure. Promote competition among broker-dealers by enforcing regulations against fixing. Rationalize prudential regulations and minimum capital requirements for brokers according to the risk they take. Promote KOSDAQ and enhance small business access to equity finance	
Enhance investor confidence in the securities market.	Ensure independence (and accountability) of securities regulatory authority and strengthen the role of KSE and other securities industry SROs (including strengthening prudential rules and their enforcement).	Steps toward these improvements in the securities market regulatory regime.
Promote the development of institutional investors/contractual savings institutions.	Encourage the creation and supervision of investment vehicles with public participation such as mutual funds and private pension funds, and remove restrictions on the exercise of their voting rights (subject to prudential rules on the proper use of these rights) to improve corporate governance.	Develop an enabling legal framework satisfactory to the Bank. Establishment of sound regulatory and supervisory regime for institutional investors/contractual savings institutions. Removal of limits on rights issues by financial institutions.
3. **Corporate Sector** 3.1 <u>Corporate Governance</u> Improve the quality and reliability of key financial information provided by banks and corporations to regulators, shareholders, and the general public.	Rationalize the institutional framework for setting standards, regulating, and overseeing the accounting and auditing profession so that an independent and self-regulating KICPA is responsible for: sponsoring and setting up an independent accounting standard setting organization comprising members of accounting profession, business, government and academia; and for setting auditing standards, regulating and overseeing the profession, and ensuring implementation of the standards consistent with international best practice.	Amend Law on External Audit and all other applicable laws and rules to effect this change.
	* Announce that financial statements of listed companies, banks and other financial institutions, as well as all joint stock companies with assets in excess of 7 billion Won, will be required to be prepared and audited in accordance with standards consistent with international best practices and standards beginning with the year 1999.	Revise accounting and auditing standards to make them consistent with international best practice, and revise relevant laws and rules as necessary to require that financial statements be prepared and audited in accordance with such standards beginning with the year 1999. This will include significant improvements in asset classification, loss and income recognition, presentation of financial statements, and

Objective	Policy Measure	Monitoring Indicators
		financial statement disclosure. Issue implementing rules for consolidated financial statements for majority owned companies and combined financial statements for all major commonly controlled enterprises, such rules to be effective not later than 1999 and applied without exemption.
	Strengthen the internal control structure of listed companies, banks, financial institutions and all joint stock companies and the related responsibility for the oversight of the internal audit function and selection of external auditors.	A study to be conducted on the introduction of audit committees of the boards of directors in Korea in accordance with international best practice. This study will be completed by Sept. 30, 1998, under TOR acceptable to Bank.
Promote effective monitoring of corporate performance by boards of directors and shareholders.	Boards of directors of listed companies, banks and other financial institutions, and large corporations to be effective decision-making bodies responsible for acting in the best interests of the company.	Submit legislation to the National Assembly to strengthen duties of directors to act in the best interests of the company. Require that listed companies, banks and major government enterprises subject to the Act on the Management Reform and Privatization of Public Enterprises include at least one outside director on their boards of directors. Preparation of a study of the role and function of boards of directors as users of corporate financial information and monitors of company management.
	Directors to be responsible to companies and shareholders for their actions.	Submit legislation to National Assembly to strengthen minority shareholder rights by lowering substantially the threshold for exercising these rights: e.g., the right to file shareholder representative suits; the right to make proposals at a general meeting; and the right of inspection of company records. Preparation of a study of the implications of introducing class action law suits by shareholders of listed companies.
Introduce market-based	* Submit to National Assembly insolvency laws (bankruptcy,	Appropriate amendment of laws.

Objective	Policy Measure	Monitoring Indicators
bankruptcy procedures and facilitate efficient liquidation of insolvent corporations.	composition, and corporate reorganization) to resolve jurisdictional conflicts, build administrative capacity, expedite procedures, enhance creditor participation in the reorganization process and establish economic criteria for initiation of the reorganization process.	
	Review laws on bankruptcy, composition and reorganization, with a view to harmonization and enhancing efficiency.	Preparation of study by end-1998 under TOR agreed with Bank and thereafter enactment of appropriate legislation.
3.2 Competition Policies Foster competition and efficiency in the financial and industrial sectors.	* Government will issue a policy statement announcing the following measures regarding the restructuring of chaebols, ensuring the full force and application of the FTA, to increase accountability and transparency and provide equal economic opportunity: • shall not permit business combinations which substantially reduce competition in a given market. • shall foster the entry and/or takeover of divested chaebol operations by new domestic or foreign firms. • shall publish information on the reasons and factors considered in permitting/disallowing business combinations among the chaebols. • further reduce the use of mutual guarantees by affiliates/subsidiaries.	a . KFTC will publish information on chaebol M &A, divestitures and restructuring within 30 days of the transaction being permitted/disallowed. b. will provide Bank with a detailed report and analysis of all such cases notified and considered, in a format to be agreed with the Bank prior to July 31, 1998.
	* Government will appoint a joint private/public Committee, with TOR acceptable to Bank, to recommend amendments to the FTA and identify measures which: • strengthen the market efficiency objectives • make its provisions fully and uniformly applicable to all economic sectors, including the parastatals and public entities • increase investigative powers. • increase sanction powers of KFTC. • provide appropriate consumer protection.	Draft and adopt appropriate legislation in accordance with best practice acceptable to Bank prior to July 31, 1998.
	* Government will issue a policy statement indicating it will take active steps to reduce public and private barriers to entry and exit and, in monopolized infrastructure services and utilities, design a	a. KFTC to provide information satisfactory to the Bank regarding application of the FTA; its application to national and foreign firms.

Objective	Policy Measure	Monitoring Indicators
	regulatory framework to promote competition, through such measures as fostering new domestic and/or foreign private sector market entrants.	b. Prepare an official position paper on regulatory reform and privatization of infrastructure services in accordance with international best practice prior to July 31, 1998
Strengthen the operational capacity of KFTC	Government will enable KFTC to strengthen its Policy Analysis and Evaluation capacity, on TOR acceptable to Bank, for the purposes of conducting in-depth studies of market structure and other elements affecting competition, including adequate authority to collect data and publish findings.	a. Appropriate decree issued. b. KFTC to prepare work plan acceptable to Bank prior to April 30, 1998. c. KFTC to develop and publish indicators affecting competition such as entry and exit of firms, changes in regulations, import penetration, foreign direct investment, M & A activity, etc.
	Develop comprehensive merger guidelines applicable to all sectors of the economy and other areas such as inter-firm collaborative agreements.	KFTC to prepare such guidelines, acceptable to the Bank, prior to July 31, 1998.
	Adopt measures to promote transparency in KFTC operations, guidelines for case selection, publishing of case information, and advocacy.	KFTC will report the number of interventions, dissemination of public position papers related to regulatory reform and fostering competition.
	* Develop strategies for institutional development of KFTC to enhance its ability to implement competition law and policy in accordance with best practice, including a detailed technical assistance program acceptable to Bank.	KFTC will provide Bank with detailed progress report, prior to July 31, 1998.
4. **Labor Market and Social Safety Net** 4.1 Labor Market Improve labor market flexibility and facilitate redeployment of labor.	* Repeal the 2-year suspension in effectiveness of Article 31 and clarify definition of dismissal for managerial reasons.	Government will submit bill to National Assembly in Feb. 1998.
	*Allow operation of private manpower leasing services.	Government will submit bill to National Assembly in Feb. 1998.
	* Commitment to relax legal restrictions on the private provision of job placement services.	New Presidential Decree revising the Employment Security Act in March 1998.

Objective	Policy Measure	Monitoring Indicators
Improve the functioning of the labor market.	Increase number and quality of public employment offices to complement private employment services.	By June 30, 1998, complete review of the effectiveness of public employment services. Develop a cooperative operational framework for public and private providers.
	Improve labor market information systems to monitor effects of adjustment and facilitate evaluation of reforms.	Conduct an annual earnings survey covering establishments with fewer than 5 workers starting Nov. 1998.
	Improve targeting, contain costs, and eliminate programs of the Employment Insurance System found to be inefficient	Prepare strategic policy report by December 1999 with a view to improving the Unemployment Benefit Scheme and to creating a more efficient Employment Security System and Job Ability Development System.
Increase worker protection.	Expand coverage of the Employment Insurance System to firms with 5 or more workers.	Extended coverage implemented by July 1998.
	* Commitment to expand coverage of the Unemployment Benefits Scheme to firms with fewer than 5 workers as early as possible.	Complete by end-1998 a feasibility report assessing options to expand coverage by January 2000.
	Ensure financial sustainability of the Unemployment Benefit Scheme	Adjust the payroll contribution rate consistent with changes in the benefit structure and the unemployment rate.
	Secure funding for retirement allowance and wage arrears in financially troubled firms. Give claimants priority creditor status and establish a public compensation fund which pre-finances these claims. The fund is to be financed from employers contributions and other sources.	Necessary change in law enacted in February 1998.
	Apply labor standards to all workers.	Expand coverage of relevant sections (including those for women and workers below the age of 18) of the Labor Standards Act to those in establishments with fewer than 5 workers in January 1999.
Reduce gender inequalities in the labor market.	Review regulations that impose high costs on women's employment.	Examine labor regulations and programs affecting women including the possibility of moving the responsibility of paying maternity and related

Objective	Policy Measure	Monitoring Indicators
		benefits from the employer to a fund financed by social insurance contributions; discuss review findings with stakeholders by December 1999.
4.2 Protecting the Poor Improve poverty monitoring.	Establish a consistent official poverty line to be used in means-testing antipoverty programs.	Publish report by March 1999.
	Develop a multipurpose national household survey system linking household income and expenditures to utilization of social services.	Develop a multipurpose household survey data set in 1998.
	Prepare a complete national poverty profile analyzing the magnitude, causes and consequences of poverty.	Publish poverty profile report in 1999.
Improve targeting of public antipoverty programs.	* Commitment to maintain constant in real terms the level of public expenditure per beneficiary on major antipoverty programs, including the livelihood program and the medical aid program.	Allocate adequate budget in 1998.
	* Commitment to expand in real terms the total budget allocations to antipoverty programs proportionately with any increase in the prevalence of poverty due to the crisis.	Allocate adequate budget in 1998.
	Undertake a thorough review of the effectiveness and efficiency of antipoverty programs based on the multipurpose national household survey.	Hold national workshop on findings in 1999.
	Rationalize targeting of antipoverty programs so as to mitigate the impact of the crisis on the poor.	Announce program of improvements following national poverty workshop by end-1999.
4.3 Pension System Securing income support for the elderly.	* Implement the planned non-contributory and means tested "social pension" financed from general budget for individuals aged 65 and above.	Allocate adequate budgetary resources in 1998 to implement the plan.
	Implement the planned extension of coverage of the national pension system to urban self-employed and to workers in establishments with fewer than 5 employees.	Issuance of appropriate decree no later than October 1, 1998.

Objective	Policy Measure	Monitoring Indicators
	* Communicate clearly that the sustainability of the current system needs to be improved and that in an upcoming reform adjustments in the contribution and benefit structure must take place.	Press communication on the need to improve sustainability of the current system prior to extension of coverage.
Improving transparency and efficiency of pension fund management.	* Agreement to gradually phase out government borrowing from pension fund reserves in the form of direct credits and to gradually phase in government borrowing from pension fund reserves in the form of sale of marketable government bonds.	In consultation with the Bank, announce by June 30, 1998, an implementation timetable, which includes appropriate revision of the Public Fund Management Act.
	Strengthen the tri-partite asset management committee for the national pension reserve fund, responsible for strategic decisions of asset allocation and determination of benchmarks for risk and return.	Necessary change in law enacted before July 1,1998.
	Strengthen the professional investment unit in the National Pensions Corporation in charge of the daily investment decisions according to the portfolio envelope and benchmarks from the committee.	Training of staff of investment unit in international financial institutions.
	Outsource a rising part of the investment decisions to private asset management firms selected in a transparent and competitive manner. The investment unit is in charge of performance monitoring and supervision, and reports investment performance on monthly basis.	Publication of a quarterly performance report by 1999.
Securing an efficient, equitable and financially sustainable pension system in the long run.	Initiate no pension reform without costing and broad-based political discussion.	
	Establish a Government Task Force to draft a White Paper on Pension Reform, with TOR to investigate the financial sustainability, equity and efficiency of the current system together with reform options, including: 1. the integration of the national pension system with the other three occupational pension schemes, 2. splitting the current national system into a basic and earnings-related component, and 3. the integration of the retirement allowance in a funded and privately managed defined-contribution plan.	Establishment of the Task Force by October 1998. Draft of the White Paper to be discussed in a tri-partite forum by 2000.

Objective	Policy Measure	Monitoring Indicators
5. **Economic Management and Institutions**		
Improve the institutional framework for economic policy making.	Implement the proposed reorganization of economic policy functions between MOFE and the Offices of the President and the Prime Minister to support improved and better coordinated economic management.	Necessary legislation passed and directives issued, specifying agency responsibilities and coordination mechanisms.
Improve debt and asset liability management.	Within a time-bound schedule: set up an external debt management office with responsibility, and capacity, for upgrading debt monitoring (including monitoring private external debt); establish a systematic coordination mechanism among the agencies involved, with clearly defined mandates, in determining external borrowing strategy and improving external asset-liability management (ALM) and linkages to macroeconomic and prudential management; and avail TA on TOR acceptable to Bank to support this upgrading of debt and asset-liability management	An external debt management office established. Improved coordinating mechanism on external borrowing strategy and ALM instituted. TA availed.
Streamline public administration.	Implement the proposed consolidation and refocusing of government ministries to improve efficiency, clarify and decentralize responsibility, and strengthen accountability.	Necessary legislation passed, directives issued, and reform work program specified

Note: Entries with an asterisk denote "prior actions," taken before SAL I Board presentation.